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In the Supreme Court of the United States

OCTOBER TERM, 1941.

No. 612.

IN THE MATTER OF:

THE VAN SWERINGEN COMPANY,

Debtor.

THE TERMINAL AND SHAKER HEIGHTS REALTY COMPANY,
(formerly Midamerica Corporation),

Petitioner,

vs.

THE VAN SWERINGEN COMPANY,

Respondent.

BRIEF OF RESPONDENT
In Opposition to Petition for Writ of Certiorari.

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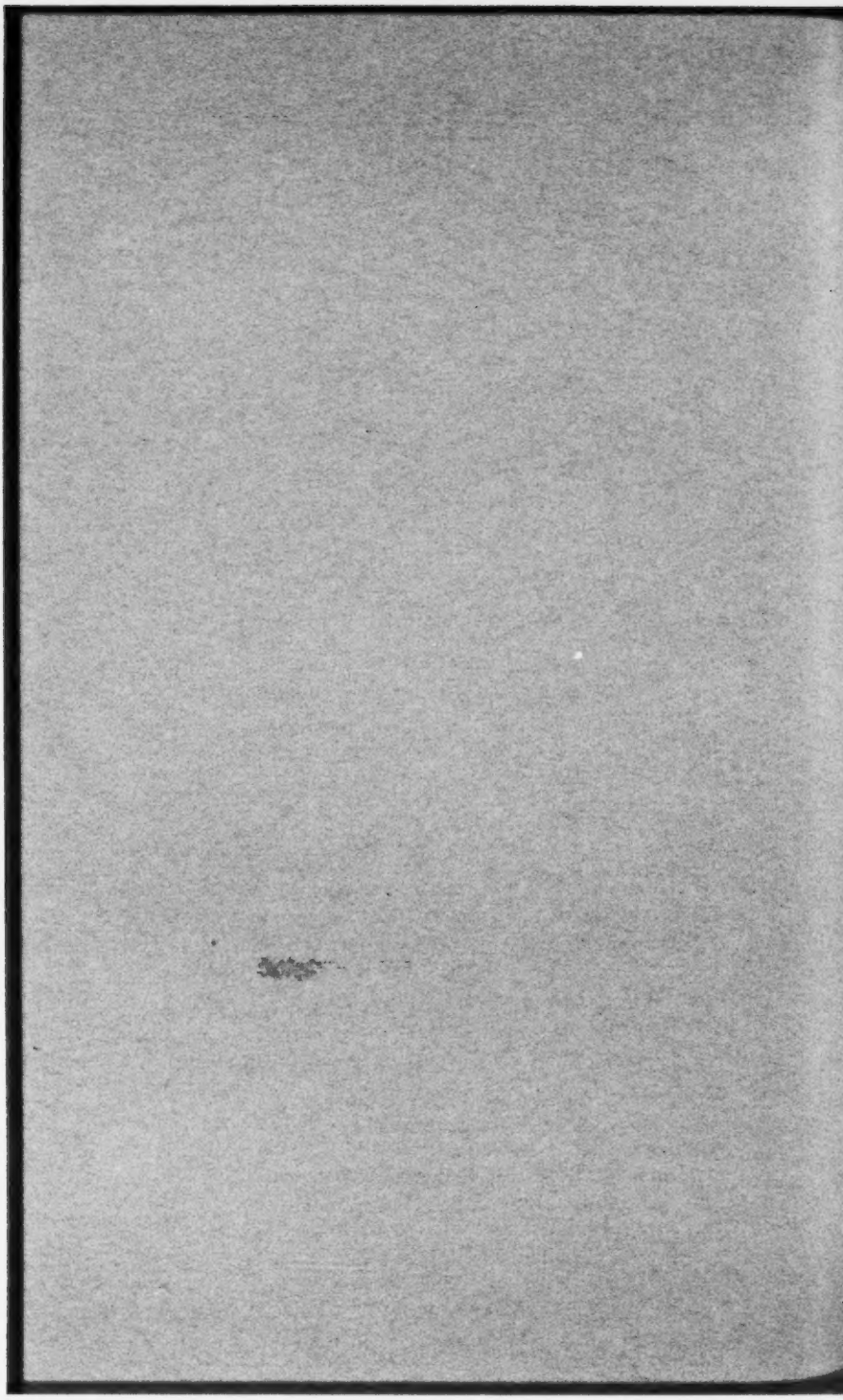

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Respondent.

BRIEF OF RESPONDENT
In Opposition to Petition for Writ of Certiorari.

The Respondent respectfully submits this brief to the Court in opposition to the petition for a Writ of Certiorari. The Petitioner, The Terminal and Shaker Heights Realty Company, will be referred to herein as "Midamerica," and the Respondent, The Van Sweringen Company, as "Debtor." This brief will treat in the order of Midamerica's petition and brief some of the parts of Midamerica's petition and all of the parts of Midamerica's brief.

PETITION FOR WRIT OF CERTIORARI.

The Debtor cannot concur in all of the statements and allegations of Midamerica's petition for a Writ of Certiorari and believes that in the interest of accuracy and justice a restatement of some portions of the petition should be made. To that end the Respondent represents the following:

1. QUESTIONS PRESENTED.

The second of the questions presented (Midamerica's petition) is not as stated by Midamerica but rather—

> (2) In the reorganization proceedings of the Debtor under Section 77-B of the Bankruptcy Act, should the rule which forbids Directors to profit at the expense of their insolvent company, by buying its notes at a discount, be applied to a case in which the directors, for selfish reasons, make their possibility of profit contingent upon self imposed and waivable conditions, utilize a self-created corporate intermediary and claim an interest in the notes through stock ownership in an insolvent corporation and a guarantee of the debt for which the notes were pledged, upon which guarantee they neither paid nor could pay anything?

2. STATEMENT.

The statement of the facts (Midamerica's petition), while it in no particular statement is inconsistent with the statements in the record below, as a whole does not present the same complete factual situation for which Debtor contends and which the Courts below found. Debtor believes that the following statement of facts more accurately and more completely sets forth the factual situation.

A. Fiduciary Relationships.

The Debtor is an Ohio corporation engaged in the development and sale of real estate. (R. 2.) All of its common and about one-third of its preferred shares were owned by The Vaness Company (hereinafter called "Vaness"). (R. 31.) O. P. and M. J. Van Sweringen at all material times were Directors of the Debtor and officers and Directors of Vaness (Stipulation Exhibit "B," R. 40-41, introduced R. 32), and with B. L. Jenks and D. S. Barrett, officers of Vaness, constituted four of the five Directors of the Debtor. (R. 40-41.) The Van Sweringens owned 80% of the common shares and claimed a benefi-

cial interest in 56% of the preferred shares of Vaness. (R. 31.) The Van Sweringens controlled, managed and directed the business and affairs of the Debtor. (Stipulation Exhibits "B" & "D," R. 40-41 and 51-52, introduced R. 32-33.)

B. The Notes on Which the Claim is Founded.

The Appellant's claim is upon notes issued by the Debtor in the face amount of $6,261,697.59 (amounting, with interest, to $8,177,023.99), representing cash theretofore advanced by Vaness or its predecessors in interest to and for the account of the Debtor. They are 6% demand notes and were pledged with J. P. Morgan & Company as part of the collateral security for a loan to Vaness from J. P. Morgan & Company in the amount of $16,000,000.00, dated October 31, 1930. This loan was guaranteed by the Van Sweringens personally (R. 13-16 and 32), but nothing was paid under the guaranty.

C. The Formation of Midamerica.

On May 1, 1935, the Van Sweringens and Vaness notified J. P. Morgan & Company that Vaness and the Van Sweringens were unable to pay the Vaness loan other than by resort to sale of the security pledged. In August, 1935, the Van Sweringens went to Ball and Tomlinson and instituted negotiations leading to the formation of Midamerica Corporation. (R. 33.) The Van Sweringens appealed to G. A. Ball for help. The Van Sweringens discussed the securities to be offered for public sale. Ball and the Van Sweringens had repeated conferences concerning the properties and securities and the management of the companies involved. The discussions between the Van Sweringens and Ball culminated in an agreement between the Van Sweringens and G. A. Ball and G. A. Tomlinson dated September 21, 1935. (Stipulation Exhibit "D," R. 51-53, introduced R. 33.) This agreement provided for the incor-

poration of Midamerica and the purchase by Midamerica of the notes involved in this case and other securities. (R. 51-53.) As part of said agreement the Van Sweringens obtained an option to purchase 8,250 common shares of Midamerica (55%), and the right to vote the shares during the option period. In order that the interest of the Van Sweringens in Midamerica be kept beyond the reach of their creditors, the option was non-assignable and in keeping with the expressed desires of the Van Sweringens (R. 53), the exercise of their option to acquire 55% of the common shares of Midamerica (8,250) for $8,250.00, plus interest at 5%, was conditioned that five of the six directors of Midamerica be satisfied that the Van Sweringens had paid or adjusted any and all claims based upon then existing commitments or relationships. (R. 52-53.) Pursuant to this agreement dated September 21, 1935, Midamerica was incorporated on September 28th, 1935. Ball and Tomlinson subscribed for 20,000 preferred shares and 15,000 common shares.

In accordance with their said agreement, the original Directors of the corporation were G. A. Ball, G. A. Tomlinson, F. B. Bernard, O. P. Van Sweringen, M. J. Van Sweringen and Charles L. Bradley. (R. 34 and 55.) The officers elected at the first meeting of Directors were O. P. Van Sweringen, President, M. J. Van Sweringen, Vice-President, and other members of the Van Sweringen administrative organization who were acting as officers or directors of Vaness or the Debtor. The Van Sweringens, by their agreement, had a drawing account by way of salary from Midamerica in the amount of $100,000.00 per year. (R. 95.)

D. Purchase of the Notes.

On September 13, 1935, J. P. Morgan & Company published a notice of the sale of the collateral securing the Vaness loan. This sale was advertised and was set for September 30, 1935. The notice of sale divided the col-

lateral into four groups. The notes in question were Parcel 23 of Group 1. The notice of sale (Stipulation Exhibit "C," R. 43-51, introduced R. 32) shows the grouping of parcels. Groups 1 and 3 comprised securities of the companies which were controlled and managed by the Van Sweringens. Adrian H. Muller & Son, Auctioneers, conducted the sale. (R. 32-33.) On September 30, 1935, at a meeting of the Board of Directors of Midamerica it was resolved that the corporation qualify as bidder and that the President, O. P. Van Sweringen, be authorized to bid for and purchase all or any part of the securities included within said Group 1 and/or said Group 3, at such price or prices as he may determine. (Stipulation Exhibit "H," R. 60-63, introduced R. 35.) O. P. Van Sweringen, Ball, Tomlinson and others attended the sale. The actual bidding was done by Col. Leonard P. Ayres on behalf of O. P. Van Sweringen for Midamerica Corporation. (R. 35.)

At the auction sale neither the Debtor, Midamerica, nor any other party made a separate bid for Item 23 of Group 1 (the notes in question). (Stipulation Exhibit "N," R. 90, introduced R. 36.) Midamerica made no bids for the individual items included in Group 1. It bid $2,803,000.00 for Group 1, which was $898,000 more than the aggregate of the separate bids made by others. The securities comprising Groups 1 and 3 were awarded to Midamerica on its group bids.

E. The Cost Price of the Notes.

After purchasing the notes in question and the other securities at the Morgan sale, Midamerica recorded the transaction in its books of account. (Stipulation Exhibit "O," R. 91-92, introduced R. 36.) It allocated a part of the aggregate purchase price to each item of the securities purchased. It determined the cost price of the notes in question to be $1.00. (R. 92.) One of Midamerica's stated reasons for journalizing the cost of the securities

in this manner was to substantiate its costs for tax purposes. (Stipulation Exhibit "M," R. 89, introduced R. 36-37.) All of the securities in Group 1 purchased, including the notes in question, were recorded in the same entry, a separate itemization being made for each class of securities. Midamerica used this cost determination in computing its income taxes in connection with the sale of shares of Cleveland Railway Company acquired with the notes in question here and the purchase of which was recorded with said notes.

F. Insolvency of the Debtor.

The balance sheets dated September 30, 1935 (Stipulation Exhibit "L," R. 83-87, introduced R. 35) show that the Debtor on the date of the purchase by Midamerica of the notes in question at the Morgan sale was insolvent. This balance sheet and the other balance sheets included in the record (Stipulation Exhibits "J, K & L," R. 66-87, introduced R. 35) with explanatory notes attached thereto disclose that the bulk of the assets of the Debtor consisted of real estate, mortgages and land contracts; unsold lots and unallotted properties were carried at more than $25,000,000.00 and were subject to five years unpaid taxes, approximating $4,000,000.00. These same balance sheets and supporting schedules and notes state that no revaluation of the assets had been made to reflect existing conditions. They also show that since prior to 1932, the Debtor had been attempting to refund and extend its bond indebtednesses exceeding $8,000,000.00, and that substantially all of the indebtedness of the Debtor was past due by 3½ years, and that Debtor had not sufficient liquid assets with which to meet its obligations as they were currently accruing. The petition of the Debtor for reorganization (R. 2-4) alleges as a jurisdictional fact that the Debtor was insolvent under the equity definition.

G. Miscellaneous.

Midamerica never offered to Debtor the opportunity to acquire the notes of Debtor purchased by it. (R. 38.) No notice was given to the creditors of Debtor of either the auction sale or the agreement of September 21, 1935, referred to above, and the Van Sweringens took no action whatsoever to acquire the notes at the sale for the Debtor.

3. SPECIFICATION OF ERRORS.

Respondent represents to the Court that the courts below did not commit the errors charged in the Specification of Errors (Midamerica's petition) or any other errors. Respondent represents that the Specification of Errors in addition is not accurate in Items 4 and 5 thereof, in that the court below did not find that the Van Sweringens realized a profit; rather, they found that there was a possibility of their realizing a profit through the allowance of the claim in the amount claimed. Also, the court below did not disregard the corporate entity of Midamerica but rather found Midamerica to be a medium used by the Van Sweringens for the realization of a profit and that therefore Midamerica could not be permitted to realize a profit which was forbidden to the Van Sweringens.

ANSWER TO ARGUMENT IN PETITIONER'S BRIEF.

The Respondent will treat herein in the order of Midamerica's brief the arguments advanced by Midamerica as reasons for the granting of the Writ of Certiorari, and respectfully submits that those arguments will be shown to be unsound and invalid.

I. MIDAMERICA'S CLAIM THAT THE DECISION OF THE COURT BELOW IS IN CONFLICT WITH A DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT ON A MATTER OF IMPORTANCE IN THE ADMINISTRATION OF THE BANKRUPTCY ACT.

Midamerica argues that *In re: New York Railways Corporation,* 82 Fed. 2nd, 739, C. C. A. 2, 1936, is a case sufficiently similar to the case at Bar that because of the claimed conflict between the holding in that case and the holdings of the courts below in the case at Bar, a Writ of Certiorari should be granted. Let us examine the cases to determine if the cases are in conflict, and if the cases are similar in their facts. In the case at Bar the courts below held that Midamerica (the creature of the Van Sweringens) could have its claim on the notes of the Debtor in the amount of $8,177,023.99 allowed in the sum of only $1.00 (its cost) against the Debtor in the reorganization proceedings, because in the acquisition of the claim by Midamerica the Van Sweringens (in a fiduciary relationship to the Debtor) breached their fiduciary duty to the Debtor in that they preferred to advance their own possibility of profit through Midamerica rather than to protect their *cestui que trust,* the Debtor, by purchasing the claim for it at a discount. The courts below thus prevented Midamerica from making a profit on a claim acquired through a breach of fiduciary duty.

In the *New York Railways Corporation* case, *supra,* the Court of Appeals held that the Fifth Avenue Coach Company was entitled to allowance in full of its claim in the amount of approximately $11,000,000.00 (the face amount of bonds of the New York Railways Corporation) in the reorganization proceedings of the New York Railways Corporation, although the bonds cost approximately $1,100,000.00, and that there was no breach of fiduciary duty on the part of the Coach Company, which owned 100% of the voting stock of the Railways Corporation, and had

6 out of 16 Directors of the Railways Corporation, and that at the time of the acquisition of the bonds in the open market the Railways Corporation did not have the financial ability to purchase the bonds.

An examination of the facts of the two cases claimed to be in conflict reveals the following:

In the New York Railways Corporation Case.	In the Van Sweringen Company Case.
1. Purchase was by the Coach Company a stockholder; was not by a fiduciary	1. Purchase was by Directors of Debtor, through Midamerica; they were fiduciaries
2. Coach Company did not control Debtor's Board of Directors or its acts	2. Van Sweringens in absolute and complete control of Debtor, its Board of Directors and its acts
3. Court found failure to buy was not due to interference or control by the Coach Company	3. Court found failure to buy was due to interference and control of the Van Sweringens
4. Debtor not found to be insolvent at the date of purchase	4. Court found Debtor was insolvent on the date of purchase
5. Price paid was substantial, approximately $1,100,000.00, 1/10 of face value	5. Price paid was nominal, only $1.00, equal to 1/8177023 of face value
6. Court found Debtor was not financially able to make the purchase	6. Court found Debtor had funds sufficient and available to make the purchase
7. Debtor was not trying to compromise its outstanding debts	7. Debtor was actively working to refund its bonds and mortgages and reduce its obligations
8. Purchase was at sales in open market	8. Purchase was at a sale the Van Sweringens helped to arrange. Public was given very short notice; creditors of the Debtor had no notice

It is respectfully submitted that because the cases are dissimilar in all important respects, and because any similarity is only in their superficial aspects, the decisions are not in conflict.

Petitioner argues that the cases are conflicting decisions on a question of frequent occurrence and considerable significance in the administration and interpretation of the Bankruptcy Act. It has been demonstrated above that the conflict is nonexistent. It is equally apparent that the case at Bar and the *New York Railways Corporation* case do not involve questions in the administration or interpretation of the Bankruptcy Act. True, both cases arose in reorganization proceedings under the Bankruptcy Act; however, that is only incidental and accidental. The questions involved in both cases categorically are not questions of interpretation of the Bankruptcy Act, and just because the questions arise in the determination of the validity of a claim presented against a corporation in reorganization bankruptcy, certainly is not reason for the assertion that the questions are of the administration of the Bankruptcy Act.

Because bankruptcy in fact precipitates the decision of many legal problems, it so happens that bankruptcy brings to light many cases of breach of fiduciary duty by officers and Directors of corporations, and Federal courts have had to decide as courts of equity whether or not fiduciary duties have been breached. The Federal courts, in *Pepper v. Litton,* 308 U. S. 295, 1939; *Magruder vs. Drury,* 235 U. S. 106, 1914, and numerous other cases, without exception have held fiduciaries to a duty of loyalty to their trusts. They have inveighed against overreaching and double dealing. They have taken a stand against the fiduciary profiting through a breach of his duty. *Canton Rolling Machine Co. vs. Rolling Mill Co.,* 168 Fed. 465, C. C. A. 4, 1909. The decisions of the Federal courts, District Courts, Circuit Courts of Appeals and the Supreme Court on these questions are entirely in accord with the decisions of the State courts.

II. MIDAMERICA'S ARGUMENT THAT THE DECISION BELOW IS IN CONFLICT WITH THE STATE LAW.

The second portion of Midamerica's brief in making the claim that the decision below is in conflict with the State law, presents a refreshing bit of wishful thinking. It solemnly proclaims a conflict, and to support the proclamation cites a New York case not at all in point. *Tiffany vs. Smith,* 124 N. Y. Sup. 85, 1910. It also cites three Federal court cases which, because they are Federal court cases and actually are not in conflict with the decisions below, are not authority for the point sought to be made. Midamerica makes the argument that if State law is to govern, the State law of New York, where the sale took place, or of Ohio, which was the State of the domicile of the debtor, should govern. In the case of *Meinhard vs. Salmon,* 249 N. Y., 458, a leading New York case, the duty of a fiduciary is clearly announced by Judge Cardozo:

> "Many forms of conduct permissible in a workaday world for those acting at arms length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."

Thomas vs. Matthews, 94 Ohio State 32, says:

> "It is the settled rule of this state that Directors must manage the corporate business with a view solely to the common interest and cannot, directly or indirectly, derive personal profit or advantage from their position which is not shared by all the stockholders."

> "The maxim *uberrima fides* of the civil law applies without limitation or restriction to their relation to the corporate property and corporate business. They occupy a strictly fiduciary relation to the stockholders and are accountable to them on principles governing that relationship."

III. MIDAMERICA CLAIMS THAT THE DECISIONS BELOW FAIL TO FOLLOW APPLICABLE DECISIONS OF THE UNITED STATES SUPREME COURT AND THE CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT ON CERTAIN IMPORTANT QUESTIONS IN THE LAW OF CORPORATE FIDUCIARIES.

The argument made by Midamerica at this point is an argument that the courts have held that a fiduciary is entitled to protect a validly acquired and previously existing interest, and that if such is the case an exception is made to the uniform rule that a fiduciary is forbidden to profit from his dealings with the beneficiary. Midamerica in this portion of its brief cites several cases, all of which were before the District Court and the Circuit Court of Appeals. Midamerica advances the argument that because the Van Sweringens owned 80% of the common stock and claimed a beneficial ownership in 56% of the preferred stock of Vaness and had guaranteed the $16,000,000.00 loan which Vaness procured from Morgan, that they had a valid interest in the notes in question which were owned by Vaness and were pledged to secure the Morgan loan. There has been no dispute whatsoever in this case that at the time of the Morgan sale and for some time prior thereto Vaness was hopelessly and completely insolvent to the extent of almost $50,000,000.00, and there is no dispute and has been no dispute in this case concerning the fact that the guarantee by the Van Sweringens of the Vaness loan was a naked guaranty on which the Van Sweringens paid nothing and on which, according to their own voluntary statement, they could pay nothing. The courts below did not disregard *Twin Lick Oil Company vs. Marbury*, 91 U. S.

587, 1875; *Arn vs. Bradshaw Oil & Gas Company,* 108 Fed. 2nd, 125, 1940, and the other cases cited by Midamerica in the third portion of its brief. The courts below found that this case did not come within the rule of those cases because they could not find any valid preexisting interest in the notes in question which could be protected by the Van Sweringens. The Debtor does not dispute the doctrine that a fiduciary, who has acquired a valid interest in an asset owned by his trust, is entitled to use legal means within the rules of fairness to protect that valid interest; however, such a doctrine cannot be properly asserted in this case because, as the courts below have found, the Van Sweringens did not have any valid interest in the notes of the Debtor through their stock ownership in Vaness, which was insolvent, or through their naked guarantee, on which they neither paid nor could pay anything.

IV. MIDAMERICA ARGUES THAT THE DECISIONS BELOW WERE AN OVERZEALOUS APPLICATION OF THE DOCTRINE OF PEPPER vs. LITTON, 308 U. S. 295, IGNORING PRINCIPLES OF EQUITY DECLARED BY THE SUPREME COURT OF THE UNITED STATES, AND THAT THE DECISIONS BELOW UNDERMINE A DIRECTOR'S DUTY OF LOYALTY.

Midamerica states that the evident purpose of the opinion below is to enforce vigorously a Director's duty of loyalty to his corporation but that the effect of the opinion will be the opposite; that it will tend to have a widespread undesirable influence on corporate directors. It is respectfully submitted that the evident purpose of the courts below in following the doctrine of *Pepper vs. Litton, supra,* can be only a desire on the part of the courts below to hold fiduciaries to those standards of honesty, decency and fairness which *Pepper vs. Litton, supra,* announces. To contend that they will have a wide spread undesirable influence on corporate directors can be ad-

mitted only if it is to be presumed that corporate directors, who are fiduciaries, should be encouraged to obtain every personal advantage at the expense of their trusts, short of clear violations of the criminal laws. If individuals are not willing to be bound in their dealings with corporations to the standards of honesty and fairness uniformly enforced by the Federal and State courts in such cases as *Pepper vs. Litton, supra*; *Meinhard vs. Salmon, supra,* and *Thomas vs. Matthews, supra,* they can refuse to act as fiduciaries.

The case of *Sanford Fork & Tool Company vs. Howe Brown & Company,* 157 U. S. 312, 1895, cited by Midamerica to support its argument, is not in point here, and that it is not in point is clear from the quotations which Midamerica makes from that case. In that case the fiduciaries did not execute a naked guaranty. The fiduciaries quite legally obtained a mortgage on the property in question because of the fact that the fiduciaries obtained money for the Company. As Midamerica's brief aptly states it, the Van Sweringens could have had a second mortgage on the Vaness collateral for their own protection. Vaness was not notoriously insolvent at that time. However, the fact is and the fact remains that the Van Sweringens did not get a second mortgage and did not have a second mortgage. The courts below in the case at Bar found that the Van Sweringens breached their duty; that "bad faith and breach of fiduciary duty were implicit." In the *Sanford Fork* case, *supra,* the courts said—"All this was done in the utmost good faith."

CONCLUSION.

The Respondent respectfully submits that the arguments advanced by Midamerica in support of its petition for a Writ of Certiorari are not sound or valid. The courts below did not err in the respects specified by Midamerica or in any other respects. The courts below, after exercising extreme patience and care in their study of the facts and the law, found that the acquisition of the notes in question by Midamerica was in violation of the fiduciary duties owed by the Van Sweringens to the Debtor and that as a corollary, neither the Van Sweringens nor their creature, Midamerica, could be permitted to realize a profit which they could have obtained only through the breach of their fiduciary duties.

Respectfully submitted,

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